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# Contracts--Right of Materialmen to Recover as Third Party Beneficiaries on Subcontractor's Surety Bond

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## Recent Cases

**CONTRACTS—RIGHT OF MATERIALMEN TO RECOVER AS THIRD PARTY BENEFICIARIES ON SUBCONTRACTOR'S SURETY BOND**—The United States Government, in awarding a building contract to a contractor, required him as the prime contractor to execute a payment bond pursuant to the provisions of the Miller Act.<sup>1</sup> The Miller Act provides that every materialman who has furnished labor or material under a government contract and who has not been paid shall have a right to sue on the prime contractor's payment bond for the balance due, provided he has given the prime contractor written notice of default within ninety days from the date he performed the last labor or furnished the last material. The prime contractor, realizing the liability imposed upon him by the Miller Act, required his subcontractor to furnish him with a payment bond so that if the subcontractor failed to pay his materialmen, the contractor would be indemnified. Upon default of the subcontractor, the materialmen failed to give the contractor the required notice as provided for in the Miller Act and as a result were barred from bringing an action on the prime contractor's payment bond. Having no action on the prime contractor's payment bond because of failure of notice, the materialmen then brought this action to recover on the subcontractor's payment bond as third party beneficiaries. The conditions of the subcontractor's payment bond included not only indemnification of the contractor but also payment by the subcontractor of all labor and material obligations. The United States District Court applying the "intent to benefit" test granted a motion to dismiss the action against the subcontractor's surety company holding that the motive of the contractor in requiring the bond was to protect himself, and not to protect the subcontractor's materialmen. *Held*: Reversed and remanded. It was wholly irrelevant for the trial judge to speculate as to the motive of the parties to the bond. The true test is whether in the payment bond the surety promised to pay money to the materialmen. By this simple test, the defendant was plainly obligated to pay "material obligations" such as that sued on. *Socony-Vacuum Oil Company v. Continental Casualty Company*, 219 F. 2d 645 (CA2 1955).

The problem presented involves selection of the proper test to be applied in determining whether labor and materialmen are protected

<sup>1</sup> 40 U.S.C.A. sec. 270(a) (1935).

third party beneficiaries under a surety bond executed by a subcontractor as required by his prime contractor. The *Restatement of Contracts* defines protected third party beneficiaries as follows:

(1) Where performance of a promise in a contract will benefit a person other than the promisee, that person is . . .:

- (a) a donee beneficiary if it appears from the terms of the promise in view of the accompanying circumstances that the purpose of the promisee in obtaining the promise of all or part of the performance thereof is to make a gift to the beneficiary or to confer upon him a right against the promisor to some performance neither due nor supposed or asserted to be due from the promisee to the beneficiary;
- (b) a creditor beneficiary if no purpose to make a gift appears from the terms of the promise in view of the accompanying circumstances and performance of the promise will satisfy an actual or supposed or asserted duty of the promisee to the beneficiary. . . .<sup>2</sup>

Under this definition of protected third party beneficiaries, do the materialmen in this case come within the category of either a donee or creditor beneficiary? The effect of the Miller Act is to impose upon the prime contractor a personal obligation to the subcontractor's materialmen, on condition that if they are not paid by the subcontractor, they can bring an action on the prime contractor's payment bond. Since under the Miller Act the prime contractor has this obligation to the subcontractor's materialmen, it follows that under the *Restatement's* definition the materialmen are creditor beneficiaries.<sup>3</sup>

While it is clear under the *Restatement's* definition that the subcontractor's materialmen are creditor beneficiaries in the contractor-subcontractor cases governed by the Miller Act, this simple solution is not reflected in the cases. Generally, the courts have attempted to apply the "intent to benefit" test based on a determination of the object or purpose in securing the bond.<sup>4</sup> This has resulted in confusion in this type of case. For example, in *McGrath v. American Surety Company*,<sup>5</sup> a case identical on its facts to *Socony-Vacuum*, the New York Court in denying recovery held that the object of the payment bond was only to indemnify the prime contractor against payments which he might be required by the Miller Act to make to materialmen of the subcontractor. Since the Miller Act imposed a personal obligation on

<sup>2</sup> Restatement, Contracts sec. 133 (1933).

<sup>3</sup> The Kentucky Court of Appeals has classified materialmen as creditor beneficiaries in the contractor-subcontractor cases using the Restatement's definition. *Jackson Lumber Company v. Union Transfer and Storage Company*, 246 Ky. 653, 55 S.W. 2d 670 (1932). (Obligation was based on a contract rather than the Miller Act).

<sup>4</sup> 77 A.L.R. 68-71 (1932).

<sup>5</sup> 307 N.Y. 552, 122 N.E. 2d 906 (1954).

the contractor, the Court concluded that his purpose was only to protect himself in requiring the subcontractor to furnish him with a payment bond and not to protect the subcontractor's materialmen.

One year later, the same Court reached the opposite result in *Daniel-Morris Company v. Glens Falls Indemnity Company*.<sup>6</sup> Except for the absence of the Miller Act, the facts were the same as in the former case. The Court concluded that the primary purpose of the bond was to benefit the materialmen by making provision for their payment. The Court also pointed to the existence of a separate performance bond which would provide indemnity to the prime contractor, thus confirming the intent to benefit directly the unpaid materialmen by the payment bond. The *McGrath* decision was distinguished on the ground that in that case the payment bond was not secured primarily to benefit the materialmen since they were already afforded full protection by the bond required of the prime contractor under the Miller Act. Yet in that case as in the *Daniel-Morris* case, the terms of the subcontractor's bond contained as one of the conditions the payment by the subcontractor of its obligations to labor and materialmen. Thus, from the "language" of the bond, there was as much opportunity for the Court in the *McGrath* case to have found an "intent to benefit" the materialmen as in *Daniel-Morris*. These two New York cases illustrate the difficulties presented under the "intent to benefit" test, especially if an attempt is made to investigate the primary object or purpose which led to the securing of the bond.

Since the "intent to benefit" test leads to confusion, what test should be applied to determine if materialmen are protected third party beneficiaries? This question can be answered by examining the opinion of the Court in the *Socony-Vacuum* case. The Court adopted the test suggested by Professor Corbin when, quoting him, it said:

[T]he third party has an enforceable right if the surety promises in the bond, either in express words or by reasonable implication, to pay money to him. If there is such a promissory expression as this, there need be no discussion of 'intention to benefit.'<sup>7</sup>

By applying this test, the Court had the task of finding a promise in the payment bond to pay the materialmen. The Court said:

But since the bond is stated to be on condition that the principal—here the subcontractor—'shall pay all labor and material obligations', the words of the condition are the full equivalent of words of direct promise.<sup>8</sup>

<sup>6</sup> 308 N.Y. 464, 126 N.E. 2d 750 (1955).

<sup>7</sup> *Socony-Vacuum Oil Company v. Continental Casualty Company*, 219 F. 2d 645 at 647 (CA2 1955).

<sup>8</sup> *Ibid.*

In reaching the conclusion that the materialmen were protected beneficiaries, the Court refused to recognize the *McGrath* case, discussed above, and based their entire decision on Professor Corbin's views as expressed in his treatise.<sup>9</sup>

The latest case found by the writer to present this problem is *Frommeyer v. L. & R. Construction Company*.<sup>10</sup> The facts are the same as in *Socony-Vacuum*, with one exception. In this case the bond was not conditioned on payment by the subcontractor of all labor and material obligations. The Court held that the materialmen could not recover on the subcontractor's payment bond because of the absence of a promise in the bond to pay materialmen. Thus, this case is not in conflict with the *Socony-Vacuum* case, because by applying Professor Corbin's test, a promise to pay materialmen was not contained in the payment bond. Professor Corbin says:

Of course, if the surety bond is so worded that the promised performance does not include payment to the plaintiff, but is merely to protect the promisee against liens, he is not a beneficiary of the contract and has no right.<sup>11</sup>

The Court in this case applied the proper test in denying recovery as did the Court in the *Socony-Vacuum* case in allowing recovery.

In summary, the Courts generally have not used the *Restatement's* definition, whereby materialmen could be considered as creditor beneficiaries in the contractor-subcontractor cases which are governed by the Miller Act. Instead, most Courts have used the "intent to benefit" test which in this type of case has led to confusion. Because under this test the courts treat the materialmen as incidental beneficiaries in many of the cases, they have denied recovery to materialmen, concluding that the contractor's object was to protect himself instead of to make a gift or confer a right on the materialmen. Since the "intent to benefit" test has not achieved consistent results in like cases, it is submitted that the Courts should adopt the test which was used in the *Socony-Vacuum* case: "Did the surety promise in the payment bond to pay money to the materialmen?" If so, recovery should be allowed, as in the *Socony-Vacuum* case, regardless of the objects, purposes or motives of the parties in securing the bond; if not, recovery should be denied, as was done in the *Frommeyer* case.

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<sup>9</sup> 4 Corbin, Contracts sec. 798-802 (1951).

<sup>10</sup> 139 F. Supp. 579 (DC N.J. 1956).

<sup>11</sup> Supra note 9 at 184.